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The New Political Macroeconomics in Modern Macroeconomics and Its Appliance to Transition Processes in Serbia

Summary: This study deals with important issues related to the new political macroeconomics and its appliance to the economic movements in Serbia, which is a country of “new democracy” as well as with transition economy. In political macroeconomics, it is a known fact that the economic policy instruments can be used for political purposes – simulated improvement of economic indicators to win the elections. These options assume specific features in transition economies, such as the Serbian economy. The political instability in Serbia, reflected in frequent elections, as well as in the diversity in political and economic goals of the key political parties leading to increasing political uncertainty in both the pre-election and post-election periods, weakened the economic system. Simultaneously, using the economic policy for political purposes to support the “pro-democratic” and “pro-European” parties proved to be paradoxically justified.

Key words: Political macroeconomics, New democracy, Fiscal manipulation, Political instability.

JEL: P16, P26, P27, E62.

The new approach to macroeconomic instability, particularly macroeconomic fluctuations, concerns political impact to macroeconomic performances because the policymakers are opportunistically and ideologically motivated politicians. These motives are essential to explain the decisions of policymakers who sometimes create economic fluctuations (booms and recessions) rather than fixing them. This approach is the subject of the New Political Macroeconomics (NPM), the development of which marked contemporary macroeconomics in the last quarter of the twentieth century.

The NPM relies on achievements in macroeconomics, theory of choice, and game theory in considering the following issues: (i) connection between politics and economics in the framework of political business cycles, inflation, unemployment, and stabilization policy; (ii) economic instability and conflicts in connection with government forms and institutional arrangements; (iii) connection between dictatorship, democracy, inequality, and economic growth; (iv) strength of a national economy and its integration into global economy.

The NPM analysis is applicable in democracies, although there are many ways to organize and run a democracy, with a variety of democratic institutions and practices. As the democratic process is not so benevolent, countries with developed democracies (the so-called “old democracies”) are characterized by strong institutions that limited incumbents’ manipulation of economic policy, both monetary and fiscal policies. However, preferences of both politicians and voters could stimulate policy-makers to manipulate, especially if they are faced with naïve voters who are not fully aware that politicians maximize their own utility. This is the main characteristic of voters in those countries that started with democratization in the 1990s, parallel with economic transition. These, “new democracies,” characterized by weak institutions, are more prone to political business cycles, especially to political budget cycles, considering limits of monetary policy, due to central-bank independency. In the “new democracies,” including Serbia, incumbents’ and voters’ preferences regarding inflation, unemployment, and economic growth become more specific as well as face constraints. These countries are faced with the alternative to abandon both the process of economic transition and democratization due to costs of economic transition, incumbents’ manipulation of economic policy, and consequently, the lack of broad public support for the changes.

1. The Nature of Modern Macroeconomics and the Role of Political Macroeconomics

Macroeconomic theory is a kind of stalemate, because its method is basically inadequate for the reality and existence it should explain. Instability and changes are not congruent with the market philosophy of cleaning the market, stability and equilibrium, agents’ rationality, their awareness, and forecasts, with the basic philosophical assumption of “as if” – *ceteris paribus* – everything else is unchangeable and permanent. Changes impose instability and the indeterminism of market behavior cannot be molded for any elegant “Procrustean bed” of macroeconomic models, those of naïve, adaptive, or rational expectations of the neoclassical economics, or the limited rationality of the new Keynesians (Athol Fitzgibons 2000).

Despite decades of intellectual efforts, no one has yet managed to explain how rational maximizing behavior of individuals, whether consumers or producers, causes just the same macroeconomic volatility and instability (Brian Snowdon and Howard R. Vane 2003).

The cause of business cycles and economic crises is not the behavior of the rational economic man, but, rather, the impossibility of its behavior as rational. This indicates that the assumption of rationality is an artificial relief, a kind of buzzword, which uses a simplified model to approach it to reality, because their individual decisions cannot be fully predicted in advance, given the imperfect knowledge and information (Otmar Issing et al. 2005; Richard T. Froyen and Alfred V. Guender 2008).

This “Crisis of Macroeconomics” was first indicated by the Nobel Prize winners, John Hicks and James Tobin, in the 1970s. Rational exercise of personal interest is incongruent with macroeconomic phenomenon of instability and business cy-

cles. Elementary economic theory, as Lionel Robbins wrote, cannot explain the cyclic quality and instability of the market economy. The crisis in macroeconomics stems from the failure of economists to successfully integrate the level of current knowledge into their theories. If the notion that there is perfect knowledge is adopted, which is the case with the neoclassical economics, then everyone could calculate the cumulative consequences of their actions, even when they are "somewhat irrational."

Modern macroeconomics assumes not only the asymmetry in the distribution of information and knowledge, but their division – some have all the available information and knowledge, while others have none. Traditional Keynesians believe in uncertainty due to lack of knowledge about the future, while Neoclassicists believe in quite the opposite – in full awareness of individuals. From this, the Neoclassicists conclude that the outcome is certain, and the Keynesians conclude that it is uncertain. If it is certain, we are moving towards one outcome because it arises from individually the same outcomes that are reachable for everyone, and with the Keynesians, it is quite the opposite.

Neoclassicists do not distinguish between the two positions: first, the market has some information about the future and second, the market reacts "as if" the future is predictable and computable. Keynesians, on their part, do not distinguish between the two positions: first, the market cannot accurately quantify the future and second, the market forces are facing an uncertain future.

Keynesians are wrong because they identify uncertainty with irrational behavior, and in doing so, they are making the same mistake as the Neoclassicists. For Neoclassicists, rationality in the condition of perfect knowledge leads to certainty, and for Keynesians, irrationality in conditions of imperfect knowledge leads to uncertainty. Basically, these are the two sides of the same coin, because it is assumed "as if" there is perfect knowledge concerning the economy (Peter J. Montiel 2003).

There is a difference between market equilibrium and economic stability: (i) there is a balance of supply and demand in the market, but an individual does not know this and changes his/her behavior in the direction of instability; (ii) there is a balance of supply and demand, an individual knows this and does not change his/her behavior, and stability is maintained.

If these differences are taken into account, then the re-research in macroeconomics must start with the business cycles. A modern approach to the cyclical movements of the economy focuses political incentives of incumbent policymakers as the sources of a kind of economic fluctuations – political business cycles (Miomir Jakšić 2007).

Classical model of connection between politics and economics entails the analysis of formulation, enacting, and consequences of economic policy for policymakers. The NPM analyses decisive influence of social and state factors – interest lobbies and groups – upon policymakers who surpass the role of economists. The government, according to the NPM, is in the very center, exposed to the influences of economics and politics.

Two approaches – opportunistic and ideological (partisan) – marked the development of the NPM since the mid-1970s of the twentieth century.

Assumptions about politicians are: (i) non-Partisan opportunistic politicians – their focal group are all voters; (ii) Partisan ideological politicians – their focal group is only their party membership.

Assumptions about voters and economic agents are: (i) non-rational behavior, non-rational expectations; (ii) rational behavior, rational expectations.

Table 1 Models of Political Macroeconomics

Assumptions about voters	Policymakers' motivation	
	Opportunistic – Politicians only care about re-election	Partisan – Policymakers are ideologically motivated
Naïve and adaptive expectations – traditional models (exploitable Phillips curve trade-off)	William D. Nordhaus (1975) Assar Lindbeck (1976)	Douglas A. Hibbs (1977)
Rational expectations – rational models (short-run Phillips curve trade-off)	Alex Cukierman and Alan H. Meltzer (1986) Kenneth Rogoff and Anne Sibert (1988) Rogoff (1990)	Alberto Alesina (1987)

Source: Snowden and Vane (2005, p. 526).

The basic political model includes: (i) voters with adaptive-naïve or rational expectations; (ii) opportunistic government focused towards all voters, or partisan-ideological government focused only towards party membership.

Introduction of government was of crucial importance, as government must take care about big actors – stakeholders – voters, political competitors, and external political and economic competitors. Government behaviors become strategic and game theory becomes essential for the explanation of politico-economic outcomes (Wendy Carlin and David Soskice 2006).

2. Credibility, Reputation, and Role of Institutions

Introduction of rational expectations into a simplified analysis of political cycles imposes the problems of economic policy inefficiency, time inconsistency, and the problem of dominant strategy in the game of formulating economic policy.

Rational political business cycles model includes the following assumptions: (i) individual actors make rational expectations in the environment of income and price rigidities; (ii) business cycles are a consequence of changes of aggregate demand; (iii) aggregate demand influences the level of output and employment, as nominal rigidities obstruct fast changes in incomes and prices; (iv) aggregate demand fluctuations obstruct attaining equilibrium employment; (v) supply shocks influence equilibrium employment, while institutional and political differences between the countries are important factors of the level of employment.

Rational behavior of the public limits the extent to which policymakers can influence the economic cycle by: (i) political decisions (behavior of the public when voting); (ii) economic policy results (via the expectations-augmented Phillips curve).

Introducing the rational behavior of voters prevents a systematic influence of the policymakers, and therefore, even the choice of particular economic policy instruments cannot be a surprise for them, which could make an impact on the real economic movements. Sources of cyclic fluctuations of the macroeconomic variables within the rational models of political cycles are: imperfect information about the character of economic environment at the disposal of the rational voters; imperfect information about the goals of policymakers at the disposal of the rational voters; and imperfect information about the capabilities of policymakers at the disposal of rational voters, which is on their competence.

Government's competence is defined in different ways in the rational opportunistic models: by capability to implement appropriate fiscal policy (Rogoff and Sibert 1988; Rogoff 1990); by providing economic growth not followed by inflation (Torsten Persson and Guido Tabellini 1990); and by isolating economy of random shocks that affect it (Cukierman and Melcer 1986).

One of the leading proponents of NPM, Daron Acemoglu, explains the differences between national economies in economic growth with two dominant paradigms – geographical and institutional. The geographical paradigm explains economic growth by dominant factors of geography, climate, and ecology, while the institutional paradigm considers institutions as essential factors in promoting investment in human, physical capital, technology, and knowledge.

Good institutions possess three attributes: (i) they establish property rights in the society; (ii) they limit all elites whose goal is rent seeking; (iii) they ensure equal opportunities for all individuals in a society in the field of employment, social security, and human rights.

To understand the path of democratic political development seems even harder than measuring democracy in one country. It is often claimed that there were two waves of democratization in the established democracies: before the First World War and after the Second World War. According to Acemoglu and James A. Robinson (2006), process of democratization is characterized by the following: (i) warranted democratic progress does not exist; (ii) monocausal explanations of democracy are not fruitful; (iii) factors of establishment and consolidation of democracy are different; (iv) fundamental conflict exists between elites and public: public is prodemocratic, while elites are nondemocratic; (v) democracy depends upon conflict between public and elites: when the benefit from democracy is greater than the cost of keeping nondemocracy, transition to democracy occurs; (vi) social outcomes are uncertain and depend upon many factors, and nondemocracy can transform to democracy and vice versa.

Economic origins of democracy could be determined by the triangle of the following factors (Acemoglu and Robinson 2006): (i) economic incentives determines the political behavior and individual act rationally according to game theory; (ii) conflicts have a key role because different social groups have their separate interests about possible social outcomes; (iii) political institutions have a central role in the process of solving conflicts, as they define future distribution of *de jure* political power.

The questions were also raised about the correlation between the level of democratic development and level of economic development (income per capita), level of development of the educational system, labor share, level of inequality of a distribution of income, and level of income redistribution. Freedom house democracy indices document the main thesis that wealthier countries are more democratic, and that there is a strong correlation between the level of income and democratization: wealthier countries (USA, Canada, Australia) are more democratic, while poorer countries (sub-Saharan Africa, South America, Central America) are less democratic. Higher inequality is strongly connected with lower level of democracy: countries with higher inequality and higher Gini coefficient are less democratic.

The third significant wave of democratization refers to democratization of the former socialist countries in the period of 1990s, which occurred parallel to significant economic changes – transformation of the former socialist economies into market economies.

3. Economic Reforms and Democratization Processes in Serbia

In Serbia, the economic system reforms began after political changes that occurred in October 2000. After a 10-year period of economic stagnation (1991–2000) marked by economic sanctions (1992–2000), exclusion from international flows of people and capital, hyperinflation (1993), millions of unemployed people, general poverty of the population, unutilized economic capacities, technological backwardness of the economy, and NATO bombing, in 2001, Serbia rapidly began a process of economic transition.

In 2000, the European Bank for Reconstruction and Development (EBRD) transition indicators for Serbia showed that there was little or no progress in implementing economic reforms, when compared with 1989, and thus, in 2000, the sum of the transition indicators was less than that in 1989 (Table 2)¹.

Table 2 Transition Indicators for Serbia (1989 and 2000)

Year	LP	SP	ER	PL	TFS	CP	BRIRL	SMNBFI	OIR	TOTAL
1989	1.00	3.00	1.00	2.67	2.00	1.00	1.00	1.00	1.00	13,67
2000	1.00	3.00	1.00	2.33	1.00	1.00	1.00	1.00	2.00	13,33

Source: EBRD (1999-2009).

To sum up, Serbia started the process of democratization and economic reforms in extremely poor economic conditions. However, in early 2001, there was

¹ EBRD determines progress in transition based on nine indicators: large-scale privatization (LP), small-scale privatization (SP), enterprise restructuring (ER), price liberalization (PL), trade and forex system (TFS), competition policy (CP), banking reform and interest-rate liberalization (BRIRL), securities markets and non-bank financial institutions (SMNBFI), and overall infrastructure reform (OIR). According to the EBRD methodology, minimal value of an individual indicator equals 1, which corresponds to the sum of 9 points for a total of indicators taken. When the sum equals 9 points, there is no progress in transition, and it is represented by 0% of transition realized.

great public support for economic and political reforms in Serbia. This support is best reflected in the election results for parliamentary elections in December 2000, where a coalition of parties (DOS) that carried the reforms won as much as 70.4% of seats in the new assembly.

As in other countries, in Serbia too, on the one hand, there were generally supported political changes that implied the development of multiparty system, public involvement in all political decisions, civil society development, and institution building. However, on the other hand, Serbian citizens were faced with huge economic costs of transition.

Owing to the economic costs of transition, the democratic process can occur as a limiting factor for the development of a new market system. However, in Serbia, there was a commitment to implement economic transition together with the development of a democratic system. Therefore, parallel with the economic transition in Serbia, it was necessary to ensure the consolidation of democracy and prevent the return of a nondemocratic order. In some moments, it seemed that the goal of maintaining the country's democratic course was more important than the economic transition, and knowing that it is necessary to have public support for that, sometimes it was decided to let go of the too radical transitional cuts to provide political support for the "pro-democratic" and "pro-European" political forces.

Table 3 Transition Indicators for Serbia – Achieved Progress in Transition²

Year	LP	SP	ER	PL	TFS	CP	BRIRL	SMNBFI	OIR	Total indicator values sum	Achieved reforms (%)
2000	1	3	1	2.33	1	1	1	1	2	13.33	14.45
2001	1	3	1	4	2.67	1	1	1	2	16.67	25.59
2002	2	3	2	4	3	1	2.33	1.67	2	21	40.04
2003	2.33	3	2	4	3	1	2.33	2	2	21.66	42.24
2004	2.33	3.33	2	4	3	1	2.33	2	2	21.99	43.34
2005	2.67	3.33	2.33	4	3.33	1	2.67	2	2	23.33	47.81
2006	2.67	3.67	2.33	4	3.33	1.67	2.67	2	2	24.34	51.18
2007	2.67	3.67	2.33	4	3.33	2	2.67	2	2	24.67	52.28
2008	2.67	3.67	2.33	4	3.67	2	3	2	2.33	25.67	55.62
2009	2.67	3.67	2.33	4	4	2	3	2	2.33	26	56.72

Source: EBRD (1999-2009).

The consolidation of the democratic system, as an important element of political and economic transition, is based on the idea that citizens are more prodemocratically oriented than the elite, for one simple reason – democracy provides citizens much more benefits than nondemocracy. The elite, on the other hand, may be encouraged to support nondemocratic processes and the forces that will increase their economic prosperity. Is there, on the other hand, any possibility to consolidate a democracy without sufficient support from the citizens, and with strong support by the

² Total scale of progress in transition according to the EBRD transition indicators goes from 9 points (0% achieved reforms) to 38.97 points (100% achieved reforms).

elite? This is probably the key issue for countries in transition, and it is extremely relevant in Serbia. It is closely related to economic trends and conditions determining the voters when choosing between different parties and also between different ideological orientations, which is exactly what political macroeconomics is interested in.

Although there is no guaranteed economic and social prosperity, or a system that provides it, the most important role in building a democratic and prosperous society lies with the institutions.

It is possible to compare the degree of the achieved level of economic transition and development of democracy in Serbia (Tables 3 and 4). The reached level of transition indicators show that in Serbia, the transition process was quickest in the first years (until 2003). Similar conclusions can be reached in the analysis of the development of democracy in Serbia. This phenomenon was caused due to the transition costs, their disproportionate transfer to certain structures of the population, as well as the negative effects of the economic reforms, which further led to resistance to the reforms and reduced public support.

Table 4 Indicators of Democracy in Serbia³

Year	EP	CS	IM	NGOV	LGOV	JFI	CO	Democratic score	Type of the regime
1999–2000*	5.50	5.25	5.75	5.50	5.50	5.75	6.25	5.67	Semi-consolidated authoritarian regime
2001	4.75	4.00	4.50	5.25	5.25	5.50	6.25	5.04	Semi – consolidated authoritarian regime
2002	3.75	3.00	3.50	4.25	4.25	4.25	5.25	4.00	Transitional regime
2003	3.75	2.75	3.25	4.25	4.25	4.25	5.00	3.88	Semi-consolidated democracy
2004	3.50	2.75	3.50	4.00	4.00	4.25	5.00	3.83	Semi-consolidated democracy
2005	3.25	2.75	3.25	4.00	3.75	4.25	5.00	3.75	Semi-consolidated democracy
2006	3.25	2.75	3.25	4.00	3.75	4.25	4.75	3.71	Semi-consolidated democracy
2007	3.25	2.75	3.50	3.75	3.75	4.25	4.50	3.68	Semi-consolidated democracy
2008	3.25	2.75	3.75	4.00	3.75	4.50	4.50	3.79	Semi-consolidated democracy
2009	3.25	2.75	3.75	4.00	3.75	4.50	4.50	3.79	Semi-consolidated democracy

Source: Freedom House (2009).

4. Transition Costs and Support for the Reforms

The key limiting factor for the economic transition in Serbia, and its further democratization, became the arising transition costs. These costs, but to even greater extent,

³ The democracy scale is a scale that goes from 7 (the lowest level of democracy – 0%) to 1 (the highest level of democracy – 100%). Democracy score (DS) is an average of ratings for the categories: electoral process (EP), civil society (CS), independent media (IM), national democratic governance (NGOV), local democratic governance (LGOV), judicial framework and independence (JFI), and corruption (CO).

* Data in the period before 2004 are given for Yugoslavia (Serbia and Montenegro).

unrealized hopes often motivated by unrealistic expectations from the process of economic transition and democratization, as well as opening the country to the world present immediately after the democratic changes, influenced the change in the public atmosphere in Serbia. This change was related to the weakening of the support for the reforms, which involved a discontinuation of certain segments of the reforms. On the other hand, the responsibility for the weakened public support for economic reforms came from the inability to establish a consensus on common economic and broader social goals.

Reduced support for the reforms has been visible in Serbia ever since 2003, and can be observed through election results. Among the economic reasons for this shift in public support were most certainly those of macroeconomic trends, such as unemployment rate, number of employed persons, GDP growth, earnings, and their growth rate. These indicators show a significant improvement of the macroeconomic trends in Serbia, but an insufficient improvement of the economic position of the most general population is also present. Thus, unemployment remains a significant problem, whereas the privatization process does not lead to the expected effects of better efficiency and improved performance of Serbian economy, but in a high percentage of privatized enterprises, it is manifested as a failed privatization.

Because of the transition cost and the disappointment of expectations regarding the improvement of living standards of the population, the opening of the country and its entry into the European integrations, as well as the construction of appropriate democratic institutions, in Serbia, one relationship has become particularly important: the relationship between *the public* and *the elite*. It is a fact that different social groups prefer different political institutions because of the way they allocate political power and resources. Theoretical assumptions say that the public prefers democracy, while the elite are against it. This is way a democracy is consolidated when the elite is neither motivated nor strong enough to jeopardize it (Acemoglu and Robinson 2006).

In Serbia, fear of returning to the old regime made the elite prefer democracy because, for the elite, the costs of establishing a democracy were lower than those they would have if the repression returned. This led to a paradox – the elite proclaimed economic reforms and further democratization, while the poor public increasingly challenged the question of the market economy system, and even the democratization process itself. In Serbia, this meant that the elite were able to abuse the democracy for the realization of their own goals. This abuse was also reflected in the use of economic policy in political purposes.

5. Political Macroeconomics of the Economic Policy in Serbia

Specifics of applying the model of political business cycles to economies in transition, such as Serbian economy, can be summarized as follows (Aleksandra Prašćević 2007): (i) specific motives of policymakers, different from those present in developed countries; (ii) voters who do not have sufficient knowledge about the market system and democratic procedure.

In Serbia, political macroeconomics of the economic policy was defined by a considerable political instability, reflected in the following: (i) frequent elections at

various levels; (ii) differences in economic goals, and even more in political goals, of the participants in the elections – the political parties that can win power and become the economic policy creators.

For the analysis of political influence on the economic policy in Serbia as a "new democracy" country, it is relevant to observe the studies of these phenomena in other "new democracy" countries, which show that it is primarily present in the area of fiscal policy in the form of political budget cycles, a term introduced by Rogoff (Rogoff 1990). Extensive reference on this subject shows that specifics of the political and economic systems of the "new democracy" countries condition much greater presence of the phenomenon of political cycles in them than in the developed democracies and developed economies, primarily in the form of higher budget deficits in pre-election periods due to growth in government spending or reduction in tax burden, as well as in the form of changes in the structure of government expenditure in favor of those expenses that are currently visible to voters or whose effects are more visible, at the expense of investment (Adi Brender and Allen Drazen 2003, 2005; Persson and Tabellini 2002; Min Shi and Jacob Svensson 2002, 2006).

The abuse of fiscal policy in Serbia in the form of fiscal manipulation has the following specific characteristics: (i) economic policymakers know the preferences of the population – income growth and price stability; (ii) economic policymakers are able to successfully manipulate economic policy, because voters are "myopic" or "selfish" – interested in improving, even in the short run, their own positions; (iii) in fiscal manipulation, economic policymakers choose the model of fiscal manipulation that targets certain groups of voters, and not the entire electorate, particularly to avoid a significant increase in the budget deficit and win votes; (iv) sources of fiscal manipulation in the pre-election are also the privatization revenues that the country has from public enterprises privatization.

6. Conclusion

The economic performances (inflation, unemployment, and growth) decisively influence voters and their behavior, and policymakers are aiming at re-election, while those in opposition strive to win and come to power. These facts are the basics of the NPM and they are applicable to both "old" and "new democracies."

Development of parliamentary democracy and economic transition are two mutually conditioned and parallel processes. The experiences of transition countries indicate that the development of parliamentary democracy has become an indispensable factor in the transition process. Although it is possible to establish market economy in an authoritarian regime, most transition economies were urged to democratization, as an unavoidable factor whose benefits should substitute, at least the majority, if not all, the negative consequences to which the economic transition, at least in the early stages, led. The new system had to be based on new political foundations of individual freedom and liberalism.

Political changes in Serbia were greatly supported by the public, but the economic reforms incurred costs that were not consistently borne by the whole nation, but only by certain social structures. In this aspect, the entire democratic process can

be questioned, because it can occur as a limiting factor in the development of new market system.

The economic policymakers in Serbia, although faced with a lack of rational subjects – the voters, who, especially in the early stages of transition, were not clearly familiar with either how the market economic system works or with the parliamentary democracy system, which is universal for the countries in transition and the "new democracy" countries – had significant limitations in terms of the abuse of economic policies that were themselves drawn from the preferences of the voters, as well as from economic and political conditions that were imposed by international factors, such as financial institutions, as well as the desire to join the European Union. These are the factors that definitely caused the situation in which neither monetary nor fiscal expansion, which would have resulted in a high deficit or inflation, could be clearly seen. Instead, here is a greater extent of changes in the structure of government expenditures, privileged position of individual economic entities, and the use of revenues from privatization.

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